Supreme Court of the United States

GEORGE D. PROVOST and CORNELIUS W. PROVOST, copartners, composing the firm of PROVOST BROS. & CO.,
Appellants,
—against—
THE UNITED STATES.

No 258

APPELLANTS' REPLY BRIEF.

THE FACTS.

In the statement of facts, counsel are in error with reference to the interest phase of the lending of stocks. They state that "sometimes the lending broker pays interest upon the money received" (page 3). That is far from a correct statement. In every normal case the broker lending the stock pays interest to the broker borrowing the stock on the money deposited by the latter with the former (Finding of Fact XI; R., p. 7). It is only in the *unusual* case that stocks are loaned "flat." Premiums are all but unknown, for if it were possible for a broker both to receive the use of another broker's money and to be paid for it as well, there would be a mad scramble among brokers for the privilege of lending stock. The custom of borrowing stock in connection with short sales is made possible only because of the unrestricted supply of

stock available to brokers, so that the lending broker may deal with the borrowing broker, in the ordinary case, on equal terms. So long as there is an unrestricted supply (and that is the usual and normal case), the broker lending the stock pays, on the money deposited with him, interest at the prevailing rate for "call loans" of money (Finding of Fact XI; R., p. 7). Just as a scarcity of stock may occasionally result in a lower rate of interest, so similarly a scarcity of money may result in a higher rate of interest. That is governed, of course, by the law of supply and demand. The fluctuations in the rate of interest, however, can in no sense be said to alter the nature of the transaction.

REPLY TO POINT I.

We cannot agree with counsel's statement that "we are not concerned about a transaction where one sells stock to be delivered at a future date where, perhaps, the seller owns or controls the stock in a distant city and requires time to procure and deliver it" (page 7). Quite commonly a short sale is made by a person who owns or controls stock sufficient to make delivery but located in a distant city or under other circumstances which make immediate delivery impossible or inconvenient.

Nor are we dealing with cases where no borrowing is necessary, for we are dealing with cases where the tax is, we insist, wrongfully imposed, not with other cases. It is idle to speak of instances where the tax is escaped. Our question relates to the ordinary case,—where the tax was laid although the stock was only borrowed. Of course, the normal transaction is one where there is borrowing.

Counsel contend that when the broker lending the stock delivers it to the broker borrowing the

stock, there is a complete transfer of legal title, and this contention counsel seeks to make good by referring to the particular certificates or pieces of paper. On page 9 of the Government's brief, it is stated that the 1917 Act "imposes the tax upon the sale or transfer of the certificates, the pieces of paper themselves, not merely on the transfer of the interest represented by a certificate."

But the Act says on its face that it was not intended to impose a tax on mere deliveries or transfers of pieces of paper without reference to the actual interest transferred. Thus, the Act says that "it is not intended by this title" to tax the transfer of pieces of paper when there is a collateral loan. If it had been the intention to tax every transfer of mere pieces of paper, Congress would never have ignored this source of revenue in the multitudinous collateral loan transactions. *Nocitur a sociis.* The Act speaks of "sales or agreements to sell." Why, if the mere transfer of pieces of paper was to be the subject of the tax?

The Government pays no attention to the special characteristics of short transactions. A pledgee of stock may do everything which the Government contends the broker borrowing the stock may do in the present case. Certainly if a pledgee may, under the authorities, exercise all the rights and powers which a transferee of title may exercise and is obligated merely to return a similar quantity of similar stock (as the broker borrowing the stock is in the present case obligated), the Government must do more than merely declare that there is a transfer of title to pieces of paper.

The suggestion that the operation of the Clearing House supports the Government's contention is scarcely worth an extended discussion. The Clearing House functions merely to facilitate brokers in making deliveries of stock certificates. Whether

such delivery is made to effectuate a sale or a loan or a pledge or otherwise does not affect its operation. The Clearing House is only what its name implies.

REPLY TO POINT II.

In our main brief we pointed out, by reference to recognized authorities, that the broker who lends the stock has only one purpose in mind, to wit: to procure the use of the money which he receives from the broker who borrows the stock. For the use of that money he pays ordinarily the same rate of interest which he would pay on a "call loan" from a bank. We have carefully indicated the reciprocal nature of the transaction, to wit: that the broker borrowing the stock procures the use of the stock and that the broker lending the stock in turn receives the use of the money at a stipulated rate of interest.

Counsel for the Government content themselves with the statement that the transactions involved in this case are not similar to bank loans. Surely they do not seriously contend that a loan cannot be effected except from a bank, and the mere assertion that a transaction such as is involved in this suit is not similar to a bank loan is an evasion of the issue. Concededly there are differences in form between a bank loan and a broker loan, but in so far as the broker who procures the money is concerned, his purpose in going to a bank and depositing securities as collateral for a loan is identical with his purpose when he goes to another broker and lends stock in return for the use of the money which he receives thereon.

The very fact that the broker lending the stock pays interest thereon at the current rate is suffi-

cient to convincingly demonstrate that he is borrowing money. It serves no purpose for the Government to look at the transaction only from the point of view of the broker borrowing the stock. Of course, he receives an advantage as well, otherwise there would be no incentive for him to enter into the transaction. As we have pointed out in our main brief, the transaction is based upon mutual and reciprocal advantages.

Counsel for the Government emphasize the unusual and rare case in which loans are made "flat" or at a premium. From reading the Government's brief, one would gather that that is the usual and customary practice. As a matter of fact it is a most unusual one, and conditions which would make it possible to make loans "flat" or at a premium occur very rarely; but even in such cases the lender of the stock may be deemed to pay interest for the use of the money, but the amount of such interest may be considered as offset by the advantage which the broker borrowing the stock receives where such stock is scarce and difficult to borrow.

REPLY TO POINT III.

The weakness of the Government's contention is shown by its effort to make something out of Mr. Maloney's appearance before the Senate Finance Committee. That appearance in no way affects the true construction of the Act. As we have stated in our main brief (page 34), this appearance is wholly immaterial. At that time the House of Representatives had already formulated and reported the 1918 Revenue Act, and the Senate Finance Committee itself gave no consideration to Mr. Maloney and did not refer to his suggestion in its report. *Non constat* but that the Committee believed that

the Act imposed no tax in such cases, and that the original ruling of the Department (in Treasury Decision 2182) was correct and would be sustained by the courts. Certainly there had been no such long continued and harmonious administrative construction the other way that it could be regarded as read into the statute when the committees and neither House referred to it.

On the other hand, counsel for the Government have completely failed to meet our argument that prior to 1918 and under statutes containing language substantially similar to the 1917 and 1918 Acts, the Treasury Department had consistently and uniformly, and for a long period of time, ruled that the lending of stocks and the return of borrowed stocks were not subject to tax. Counsel for the Government are hard put to it to explain away the complete and manifest inconsistency between the Treasury Department's interpretations of the 1898 and 1914 Acts, and their ruling in Treasury Decision 2685 under the 1917 Act. In a single page (page 17) of the Government's brief, three different explanations are given of this inconsistency, all of which are equally unavailing.

First, counsel say that neither the 1898 Act nor the 1914 Act contains the clause "or transfers of legal title to shares or certificates." A comparison of the 1898 and 1914 Acts with the Revenue Act of 1917 completely discredits the Government's claim that there is any material distinction. If anything, the 1898 and 1914 Acts were broader in their terms than the 1917 Act; for while the latter Act contains the clause "or transfers of legal title to shares or certificates of stock," the former Acts contained the words "or transfers of shares or certificates of stock." If there is any difference in the scope of these laws, it might be said that the earlier Acts

had a broader scope than the 1917 and 1918 Acts, in the view that the former included all transfers whether title passed or not.

Secondly, counsel for the Government urge that the facts set forth in Treasury Decision 2182 distinguish that decision from the ruling contained in Treasury Decision 2685. Counsel say that the distinction lies in the fact that in the circumstances stated in Treasury Decision 2182, the transfer does not represent a change of ownership. The facts are fully set forth in the Treasury Decision itself, and we respectfully insist that if the facts therein set forth do not constitute a change of ownership, the facts set forth in this action, as found by the learned Court below, do not represent a change of ownership. We need not burden the Court with a further discussion of the identity of the transactions involved in this claim with those set forth in Treasury Decision 2182. They are sufficiently discussed on pages 22 and 23 of our main brief. Suffice it to say, if the borrowing of stock because of "non-arrival" of the stock sold does not represent a change of ownership, upon what theory can it be claimed that the borrowing of stock for any other reason does represent a change of ownership?

Thirdly, counsel for the Government contend "that the chances are that the Treasury officials were not cognizant of the mechanics of borrowing stock during the years in which the 1898 and 1914 laws were in effect, even though the language of those Acts might be susceptible of construction which would justify the tax." There is nothing which justifies this assumption, as the Treasury Officials, who were necessarily in close touch with the business of stockbrokers in connection with the administration of those Acts, could not have overlooked so common a practice. The presumption

must necessarily be to the contrary. The very promulgation of Treasury Decision 2182 establishes on its face knowledge on the part of the Treasury officials of the practice of borrowing and returning stocks.

We suppose that it will not be denied that precisely the sort of transactions, of the taxation of which we here complain, were not taxed under the Acts of 1898 and 1914, and that the Treasury Department construed its ruling in Treasury Decision 2182 as definitely establishing their immunity from the tax.

Respectfully submitted,

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